

Internal Revenue Service

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Date: December 07, 2010

December 07, 2010

Legend

Taxpayer =

State =

Asset Purchase Agreement =

Date 1 =

Date 2 =

Date 3 =

Buyer =

\$k =

\$m =

\$n =

\$p =

\$q =

\$r =

\$s =

\$t =

\$u =

\$v =

\$w =

\$x =

\$y =

\$z =

a% =

b% =

c% =

d% =

e% =

f% =

Event =

Period =

Year 1 =

Year 2 =

Year 3 =

Year 4 =

Dear _____ :

This is in reply to Taxpayer's request for a ruling requesting permission to use an alternative method of basis recovery under § 15a.453-1(c)(7)(ii) of the Temporary Regulations under the Installment Sales Revision Act of 1981 to report payments from a contingent payment sale. In accordance with § 15a.453-1(c)(7)(ii), Taxpayer filed its ruling request prior to the due date (including extensions) of its Year 1 tax return.

Taxpayer is a closely-held State limited liability company with eleven individual shareholders that is taxed as an S Corporation for federal income tax purposes. It uses an accrual method of accounting and files its returns on a calendar year basis. On Date 1, Taxpayer sold substantially all of its operating assets to an acquisition subsidiary of Buyer pursuant to the Asset Purchase Agreement.

Under the terms of the Asset Purchase Agreement, Buyer agreed to (i) pay Taxpayer a fixed cash payment and three contingent payments and (ii) assume certain current liabilities of Taxpayer.

Under the Asset Purchase Agreement, the contingent payments are paid only if Buyer achieves certain consolidated target Earnings Before Interest, Taxes, Deprecation and Amortization (EBITDA) goals. The targets for each earn-out payment are based on EBITDA levels of \$p for Year 1, \$q for Year 2, and \$r for Year 3 (EBITDA target). In any year that the EBITDA target is met, the consideration due to Taxpayer in the following year is \$s, plus a% of excess earnings. Excess earnings are defined as the amount of EBITDA achieved by Buyer in an applicable earn-out period in excess of the consolidated EBITDA target. If for any earn-out period, Buyer does not achieve the EBITDA target, then Buyer does not pay any contingent payment the following year.

At closing, the Buyer paid Taxpayer \$t and placed \$u in escrow, subject to substantial restrictions on Taxpayer's right to receive the funds until Date 2.

The purchase price was reduced by the "proportional related entity net debt" and further reduced by \$v, the excess of the working capital target set in the Asset Purchase Agreement over the actual working capital target determined at closing. The purchase price was increased by \$k of liabilities that Buyer assumed. Thus, Taxpayer represents that the total selling price for federal income tax purposes was \$m, which includes \$n of depreciation recapture and \$x of accounts receivable, inventory, and other working capital items.

Taxpayer represents that the total basis in the assets sold is \$w, which includes \$x of basis in accounts receivable, inventory, and other working capital items. Therefore, of the total basis in the assets sold, only \$y is subject to installment treatment under § 453 of the Internal Revenue Code. Accordingly, using the normal basis rules in § 15A.453-1(c)(3)(i), \$z of basis is allocated to each of the four years in which payments may be received under the Asset Purchase Agreement.

Taxpayer's business operations through the date of the asset sale were primarily in the oil and gas services industry. Taxpayer provided pipe coating, fabrication and bending services to the oilfield industry. Since the time of the sale, there was an Event on Date 3. Governmental actions related to the Event have affected the principal market of the business that Buyer purchased, and thus, decreased demand for that business' products. The Event has also resulted in many of Buyer's customers delaying contracts, as well as Buyer reducing the workforce at the plants it purchased from Taxpayer by b% in Year 2. In addition, demand for products of Taxpayer's former business has decreased due to increased competition, as well as the decline in the price of crude oil.

Taxpayer has represented that the EBITDA for Year 1 was below the EBITDA target for Year 1, and thus, no earn-out payment was paid in Year 2. Due to the consequences described above from the Event, Taxpayer anticipates a significant decline in revenues for Year 2 and Year 3. In addition, for Taxpayer to be entitled to a contingent payment for Year 2 and Year 3, EBITDA would have to equal c% and d% of EBITDA, respectively, for Period. Thus, Taxpayer represents that Buyer will not meet the earn-out targets for Year 2 or Year 3.

Based on the foregoing, Taxpayer asserts that the normal basis recovery rule of §15a.453-1(c)(3) would substantially and in an inappropriately defer recovery of its basis on the sale of the assets.

RULING REQUESTED:

Taxpayer requests a ruling allowing it to use an alternative method of basis recovery, as provided under § 15a.453-1(c)(7)(ii). Under its alternative method of basis recovery, Taxpayer proposes to allocate the same ratio of basis to each installment payment as that installment payment bears to the estimated amount of aggregate payments to be received by Taxpayer during the four years in which payments could be received. Because Taxpayer does not anticipate receiving any contingent payments, Taxpayer would allocate e% of basis to Year 1 and f% of basis to Year 2.

LAW AND ANALYSIS:

Section 453(a) provides that, except as otherwise provided, income from an installment sale is taken into account under the installment method.

Section 453(b)(1) defines installment sale to mean a disposition of property where at least one payment is to be received after the end of the taxable year in which the disposition occurs.

Section 453(c) defines “installment method” as a method under which the income recognized for any taxable year from a disposition of property is that proportion of the payments received in that year which the gross profit (realized or to be realized when the payment is completed) bears to the total contract price.

Section 15a.453-1(c)(1) defines a “contingent payment sale” as a sale or other disposition of property in which the aggregate selling price cannot be determined by the close of the taxable year in which such sale or other disposition occurs. Unless a taxpayer makes an election under § 15a.453-1(d)(3), contingent payment sales are to be reported on the installment method.

Section 15a.453A-1(c)(3)(i) provides that when a stated maximum selling price cannot be determined as of the close of the taxable year in which a sale or other disposition occurs, but the maximum period over which payments may be received under the contingent sale price agreement is fixed, the taxpayer’s basis (inclusive of selling expenses) shall be allocated to the taxable years in which payments may be received under the agreement in equal annual increments.

Section 15a.453-1(c)(7)(i) generally provides that the normal basis recovery rules set forth in § 15a.453-1(c)(3) may, with respect to a particular contingent payment sale, substantially and inappropriately defer recovery of the taxpayer’s basis.

Section 15a.453-1(c)(7)(ii) provides that the taxpayer may use an alternative method of basis recovery if the taxpayer is able to demonstrate prior to the due date of the return including extensions for the taxable year in which the first payment is received, that application of the normal basis recovery rule will substantially and inappropriately defer recovery of basis. To demonstrate that application of the normal basis recovery rule will substantially and inappropriately defer recovery of basis, the taxpayer must show (A) that the alternative method is a reasonable method of ratably recovering basis and, (B) that, under that method, it is reasonable to conclude that over time the taxpayer likely will recover basis at a rate twice as fast as the rate at which basis would have been recovered under the otherwise applicable normal basis recovery rule. The taxpayer must receive a ruling from the Internal Revenue Service before using an alternative method of basis recovery.

Section 15a.453-1(c)(7)(ii) further provides that the taxpayer must file the request for a ruling prior to the due date for the return including extensions. In demonstrating that application of the normal basis recovery rule would substantially and inappropriately defer recovery of the taxpayer’s basis, the taxpayer in appropriate circumstances may

rely upon contemporaneous or immediate past relevant sales, profit, or other factual data that are subject to verification. The taxpayer ordinarily is not permitted to rely upon projections of future productivity, receipts, profits or the like. However, in special circumstances a reasonable projection may be acceptable based upon a specific event that has already occurred (e.g., corporate stock has been sold for future payments contingent on profits and an inadequately insured major plant facility of the corporation has been destroyed).

Taxpayer has shown that based on Event and its consequences, increased competition, decreased demand, as well as the decline in the price of crude oil that Taxpayer will not receive any earn-out payments in Year 3 or Year 4.

CONCLUSION:

Based on the information provided and each representation made, Taxpayer's proposed alternative method of basis recovery (i) represents a reasonable method of basis recovery and (ii) will result in basis recovery at a rate twice as fast as the rate which basis would be recovered using the normal basis recovery rules. Accordingly, we conclude that Taxpayer may use its proposed alternative method of basis recovery for the sale of assets under the Asset Purchase Agreement, which are subject to installment treatment under § 453 but only if Taxpayer does not receive any contingent payments in Year 3 or Year 4.

The rulings contained in this letter are based upon information and representations submitted by the taxpayer and accompanied by a penalty of perjury statement executed by an appropriate party. While this office has not verified any of the material submitted in support of the request for rulings, it is subject to verification on examination.

Except as expressly provided herein, no opinion is expressed or implied concerning the tax consequences of any aspect of any transaction or item discussed or referenced in this letter.

A copy of this letter must be attached to any income tax return to which it is relevant. Alternatively, taxpayers filing their returns electronically may satisfy this requirement by attaching a statement to their return that provides the date and control number of the letter ruling.

This ruling is directed only to the taxpayer requesting it. Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.

In accordance with the Power of Attorney on file with this office, a copy of this letter is being sent to your authorized representative.

Sincerely,

Michael J. Montemurro
Chief, Branch 4
Office of Associate Chief Counsel
(Income Tax & Accounting)